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AGRICULTURAL ECONOMICS  
& RURAL SOCIOLOGY

**THE POLITICAL ECONOMY OF RURAL LOAN RECOVERY:  
EVIDENCE FROM BANGLADESH**

by

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September 1992

AGRICULTURAL ECONOMICS SOC.  
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## **Abstract**

The rural loan recovery problem in developing countries is frequently analyzed from the perspective of borrowers or financial institutions. But a frequently overlooked problem is that borrowers often are discouraged to repay and/or institutions are not aggressive in loan recovery because governments intervene in rural financial markets to increase the prospects of getting re-elected. This political intervention may undermine the effectiveness of measures such as increasing real interest rates to improve loan allocation and recovery. A failure to address this political dimension in loan recovery analysis may lead to incorrect policy prescriptions. This paper provides an empirical analysis of how political interventions affect rural loan recovery in Bangladesh in the period 1980 to 1989. The results indicate that the negative effect of political intervention in loan allocation and recovery outweighs the effect of positive real interest rates. The government in Bangladesh intervenes in rural loan allocation and recovery formally through policies -interest exemptions, credit committees and interest rates - and informally through elected local government officials and local socio-political leaders. The intensity of informal intervention is expected to increase during an election period. Five variables - inflation rate, election years, interest exemption years, credit committee years and bank type - were included in the model used to explain loan recovery. The empirical results showed that elections, inflation rates, credit committees, and bank type affect rural loan recovery negatively, while interest exemptions affect it positively.

# **THE POLITICAL ECONOMY OF RURAL LOAN RECOVERY: EVIDENCE FROM BANGLADESH**

by

**M. A. Baqui Khalily and Richard L. Meyer<sup>1</sup>**

Until recently, banks and governments in many less developed countries considered providing cheap credit to rural households under the supply leading strategy as an effective method to achieve comprehensive rural development (Patrick). This approach has been challenged by several economists (Adams; Fry; Gonzalez-Vega; McKinnon; Shaw; Von Pischke) who argue that it leads to the inefficient allocation of resources and to credit-rationing because of excess loan demand and intervention in the lending decision-making process. The efficient allocation of funds has been at the front of this neo-liberal thesis. Interest rate reform has been the major policy prescription that has been proposed by reformers based on the argument that high interest rates would screen out the demand for credit for low rate of return projects. This approach has been accepted in several Asian countries including Bangladesh, Indonesia, Nepal and the Philippines. The Bangladesh government has adjusted its interest rate structure several times in recent years. Rural lending rates were increased significantly from 7 percent in 1973 to 16 percent in 1989. But the rural loan recovery rate declined sharply from 52 percent in 1983 to 18 percent in 1989

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despite the interest rate reform. Such low recovery rates not only affect the viability of rural credit institutions, but also affect credit turnover (Khalily; Meyer and Srinivasan).

The problem of loan recovery in LDCs has been addressed by researchers from different perspectives. Often times it has been attributed to the idea that (a) rural loans are risky, and (b) rural borrowers are too poor to repay (Donald). Some analysts have argued that low recovery rates are due to lending policies, loan targeting, lender unwillingness to recover loans, and the management ability of bank employees (Braverman and Guash; Gregory et al., Maharajan et al., Von Pischke et al.). But a frequently overlooked problem is that borrowers are discouraged to repay and/or lenders can not recover loans because of political intervention in rural financial markets (Blair; Kane). This paper presents an empirical analysis of how political intervention affects rural loan recovery in Bangladesh, and shows how it undermines the effectiveness of positive real interest rates in stimulating loan recovery. Although politics are thought to affect loan recovery, no study has been found in the literature that reports an empirical test of the relationship.

Three basic expectations about loan recovery in Bangladesh provide the framework used in this paper. First, honest borrowers may not be able to repay loans on time because of fluctuations in production and/or unforeseen contingencies. However, a shortfall in income in one period may be offset by an increase in another period so honest borrowers are expected to eventually repay their loans. Second, delinquent borrowers that are under the political protection of their sponsors can avoid repaying loans. Third, government intervention in rural loan allocation and recovery, formally through financial policies and

informally through local government officials and political leaders, negatively affect loan recovery.

### **THE RURAL BANKING SYSTEM AND TARGET LOAN RECOVERY**

The banking sector in Bangladesh prior to 1981 was largely dominated by public sector banks - six Nationalized Commercial Banks (NCBs) and two Development Banks. There were only a few foreign banks in the private sector. But the policy of privatization adopted by the government in 1981 led to the denationalization of two of the NCBs and the creation of 10 local private banks. Like the foreign banks, the local private banks do not have branches in rural areas because they consider rural lending too risky. Apart from the cooperative system, today the rural financial markets in Bangladesh essentially consist of the branches of four nationalized commercial banks (NCBs) and two government-owned agricultural development banks (BKB and RAKUB). Since the public sector banks are predominant, government intervention can occur in rural loan allocation and recovery and can undermine the effectiveness of financial policies, particularly interest rates.

The rural banking system has undergone significant changes since 1977 because of the government's supply-leading financial strategy and the introduction of a "two-for-one" branching policy by the Bangladesh Bank (Central Bank). This branching policy required banks to open two rural branches for one urban branch so rural loans could be disbursed more effectively. As a result, the rural banking network expanded from 1,094 branches in 1977 to 2,851 in 1981. This growth slowed, however, following suspension of the policy in 1981. During the period 1976-91, the amount of total rural loans made increased by about

87 times, while the rural banking network increased by 8 times (Khalily, Meyer and Hushak). Rural bank managers make two types of loans: target and non-target. Target loans are government sponsored loans made under terms and conditions set by the Bangladesh Bank, while non-target loans are made by banks using their own deposits. This paper analyzes the problem of recovering target loans.

The loan recovery rate is defined as the percentage of target loans recovered relative to total recoverable target loans (principal plus interest). Table 1 reports the target loan recovery rate by bank type. Three major findings emerge from the table. First, the recovery rate shows a declining trend from 1980-81 to 1988-89. Second, the recovery rate improved marginally in 1983-84 relative to the previous year, and substantially in 1986-87 relative to 1985-86. The government granted interest exemptions to borrowers in flood and cyclone affected areas in 1984, and to all borrowers in 1987. Interest exemptions are expected to stimulate recovery in the short run as borrowers take advantage of these special repayment conditions, but are expected to have a negative impact on long run recovery. Third, the recovery rate differs by the two bank types - commercial and development banks - probably because of the differences in management ability and banking technology.

Generally, most target loan borrowers try to repay their loans. Honest borrowers may not be able to repay loans when due because of production fluctuations or unforeseen contingencies, but it is expected that they will eventually repay. Meyer and Srinivasan, using data on short-term loans for the period 1979-84 for 89 rural bank branches, showed that about 70 percent of the principal amount of recoverable loans was recovered within five years after the due date. Borrowers under the political protection of their sponsors,

however, have a lower repayment rate (Khaled). Khaled showed that elected chairmen and members of rural local governments who are the most powerful in terms of rural power structure and influence did not repay any loans and no legal actions were taken against them. Not only did they not repay their own loans, they were instrumental in supporting their clients to also not repay their loans. Consequently, the overall loan recovery rate has been negatively affected by political intervention.

### **RURAL POWER STRUCTURE, POLITICS AND RURAL FINANCE IN BANGLADESH**

Political intervention in the allocation of rural loans is quite common in developing countries. The government intervenes in the rural lending decision-making process as a tool for getting re-elected. One of the crucial factors in affecting elections is the perception of voters. There are at least two ways for a regime to influence voter perceptions: (a) through achieving economic growth with low inflation and unemployment (Frey and Schneider); and (b) through distributing economic and financial benefits directly to voters. In a developing country like Bangladesh where democratic institutions are weak and the government has been unstable, it is difficult for a government to influence voter decisions through the first approach. The latter approach appears to be more popular with the government as it tries to directly influence voter decisions.

Since the majority of the voters live in rural areas, the government can try to influence their decisions by distributing financial benefits to them through rural financial markets in two ways: first, formally through rural financial and lending policies, and, secondly, informally through socio-political leaders. The role of socio-political leaders

depends on the rural social structure. When socio-political leaders play a dominate role in the rural society, the government may ensure their participation in local government and rural financial markets.

In a faction based rural society as in Bangladesh, the traditional rural power structure is dominated by big farmers (Bertocci; Chowdhury; Islam; Wood; Zaidi). In each faction large landowners represent the patrons, while the other members of the faction are the clients. The nature of the relationship between patrons and clients and the degree of influence of the patrons dictates the pattern of linkage between national and rural politics through different types of economic and financial policies. Empirical studies have shown that large landowners and faction leaders dominate the local rural government units (Chowdhury; Rahman; Wood). Because of the influence of these large landowners and faction leaders who are patrons over the members of their factions, they are patronized by the government through their role in local government and their involvement in the distribution of relief goods in food for work programs and agricultural credit (Chowdhury; Tepper; Wood).

Islam identified three types of brokers that link rural villages with urban areas in Bangladesh. First, there are a group of brokers who patronize their clients and voters. The local political leaders and local government officials belong to this group. The second group consists of educated people and traders acting as middlemen between government officials and rural people. The third group of brokers are urban agents of political parties who by their association with the bureaucrats and political leaders in power can promote public issues and initiate development programs for the rural people. A similar conclusion



regarding rural social and power structure was also found by Wood. Given this pattern of rural social and power structure and the relationship between rural and national politics, a government can maximize its political gains by patronizing the rural patrons through its programs and rural financial policies.

### **FORMAL INTERVENTION THROUGH FINANCIAL POLICIES**

The Agricultural Credit Department (ACD) of the Bangladesh Bank designs target loan programs and sets the terms and conditions such as the eligibility of borrowers, maximum amount to be lent per loan, nature of loan supervision, and type of loan documentation that is required. The amount of target loans to be distributed by a bank is also set by the ACD. The target for each bank branch is set by its central office based on local economic characteristics and the operational size of the branch. As noted above, the distribution and recovery of target loans is constrained by financial policies which permit the government to formally intervene in the lending and recovery program of rural branches. The major policies that are likely to affect the rural loan recovery rate are interest rates, credit committees, and interest exemptions.

#### **Rural Lending Interest Rate Structure**

The nominal interest rate structure for rural loans has been changed five times during the period 1973-89 (Table 2). Interest rates on short term target loans were more than doubled from seven percent in 1973 to sixteen percent in 1989. The major changes were made during the 1980s and the present interest rate of 16 percent was introduced in 1983. Given a low and declining inflation rate since the early 1980s, the 1983 increase contributed

to a positive real interest rate. Real interest rates increased from one percent in 1983 to about 9 percent in 1989. Prior to 1983, however, the real interest rate was negative and was as high as a negative 70 percent. Although the real interest rate on rural target loans has increased significantly the past two decades, the loan recovery rate declined sharply from 52 percent in 1983 to 18 percent in 1989. This inverse relationship appears to be inconsistent with the neo-liberal thesis about interest rates. The problem is that although interest rates increased, the political intervention in rural loan allocation and recovery continued to exist. Therefore, the effectiveness of high positive real interest rates in influencing a more efficient allocation and recovery of loans has been undermined by political intervention and other policy distortions.

#### **Credit Committees**

Credit Committees, created at the direction of the government in 1983, were intended to be involved in both the process of allocating and recovering target loans. These committees exist at the three tiers of local government - Union Council, Upazila and District. The credit committee at the union level, consisting of the chairman and members of the council, bank branch managers and block agricultural extension supervisors, is involved in rural lending by preparing lists of potential borrowers, by recommending loan amounts, and by assisting bank managers in recovering delinquent target loans. The committees at the upazila and district levels are essentially entrusted with the tasks of general supervision and follow up.

The effectiveness of these committees in the allocation and recovery of target loans is questionable since the chairman and committee members are elected by the voters for

four-year terms. In addition, there is no defined criteria for use in preparing the list of potential borrowers. The re-election objective of elected local government officials is likely to enter into the preparation of these lists. They are likely to promote or sponsor their particular clients and expand their political base for re-election by including in the list the names of their clients and potential voters. The loan recovery authority assigned to the credit committee is likely to affect the loan recovery efforts of the branch managers. Until 1987, the rural branch managers did not have any flexibility and authority in selecting borrowers, except to choose persons included in the list, and in recovering targeted rural loans. In 1987, the branch managers were finally given absolute authority and responsibility to select borrowers, and to disburse, monitor and recover targeted rural loans.

### **Interest Exemption Programs**

Five interest exemption programs were implemented during the 1982-1991 period. The basic objectives were to ease the loan burden of the borrowers and to encourage them to repay overdue loans. The interest exemption programs announced in 1984 and 1985 provided for interest exemptions and loan rescheduling without any penalty interest for borrowers affected by natural calamities. The 1985 announcement exempted interest only for cyclone-affected borrowers. It did not, however, provide for loan rescheduling (Rashid). The 1986 and 1987 interest exemption programs aimed at improving the recovery rate and were applicable country-wide for all types of crop loans up to Taka 10,000<sup>2</sup> (including principal, interest, and service charges). The announcement in 1991 by the new democratically elected government as part of its election promise exceeded the earlier exemptions in terms

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<sup>2</sup> In this period, 30 Taka were approximately equal to \$1 US dollar.

of coverage. It provided for exemption of principal, interest and overdue interest penalties up to Taka 5,000. The earlier announcements generally did not provide for principal exemption. The 1991 announcement not only contributed to revenue loss but also to capital loss for the banks because the exempted principal means that the banks have to compensate depositors out of their capital and/or profits. The total cost of the 1991 announcement for the commercial and development banks has been estimated at 350 million Taka.

There has been no significant study of the effects of the interest exemption programs on loan recovery rates. But the frequency of these programs has contributed to expectations about future interest exemptions and this is expected to contribute to the low and declining recovery rates.

### **INFORMAL INTERVENTION THROUGH ELECTIONS**

In addition to its direct formal intervention in financial markets through policy-making, the government can also informally intervene in the target loan allocation and recovery efforts of bank branch managers. A government is not likely to support a loan recovery drive and strict borrower selection procedures during an election period because of the negative impact it may have on some borrowers. During an election period, local government officials and elected representatives will likely intervene in target loan allocation and/or recovery efforts so that potential voters can more easily get loans and borrowers can avoid the pressure of bank officials to repay loans. This informal intervention by local political leaders and government officials may always exist but its intensity is likely to increase in election years.

### A LOAN RECOVERY MODEL

A simple recovery model was developed for this study to evaluate the impact of political interventions in rural target loan recovery based on the literature reviewed and the nature of the interventions discussed above. Following Frey and Schneider, the general framework of the model is specified as follows:

$$\begin{aligned} & \text{MAX } U(.) \\ & \text{S.T. } V(t) > V(t)^* \end{aligned} \quad (1)$$

$$V(t) = f(\text{POLIT}, \text{ECOPOL}, \text{RFMPOL}, \text{SOCIO}) \quad (2)$$

The basic objective of government is to maximize its utility function of getting re-elected subject to the constraints (1) and (2). Constraint (1) specifies that the government will have to get a minimum number of votes,  $V(t)^*$ , to be re-elected. The second constraint indicates that the voting decision of voters is a function of political intervention (POLIT), macro-economic developments (ECOPOL), rural financial policies of the government (RFMPOL) and other socio-cultural (SOCIO) factors.

Constraint (2) establishes the relationship between the political motives of the government and the recovery behavior of rural bank branches which is shown in Figure 1. As diagramed, the basic objective of the government is to influence voter perceptions through local political leaders, rural financial markets, macro-economic variables and other socio-cultural factors. A low recovery rate is assumed to positively influence voter perceptions towards the government.

Four policy variables - interest rates, interest exemptions, credit committees and informal intervention in loan allocation and recovery - are identified as the ways the rural

financial markets influence voter decisions and the loan recovery rate. The equation explaining loan recovery behavior is specified as:

$$Recovery = \alpha_0 + \alpha_1 ELEC + \alpha_2 INFL + \alpha_3 INTEXEM + \alpha_4 CRCOM + \alpha_5 BANK \quad (3)$$

where INTEXEM (interest exemptions) and CRCOM (credit committees) are dummy variables representing financial policy variables that are given the value of one in the years when interest exemptions and credit committees are in effect, and zero otherwise. The variables representing ELEC and BANK are dummy variables in which election years, and NCBs are given the value of one and zero otherwise. INFL (inflation) represents both macro-economic reforms and real interest rates. Since nominal interest rates are constant for all banks, the inflation rate influences real interest rates. It has been argued that as inflation reduces the real interest rate it may negatively affect recovery if borrowers develop expectations of high future inflation rates (Von Pischke et al.). The recovery equation is expressed in linear form and the estimation errors are assumed to be normally distributed.

Formal government intervention through financial policies is captured, as discussed above, by variables representing credit committees and interest exemption programs. Interest exemption programs are expected to have two major effects: (a) they generate political support for the government in election years since they provide direct financial benefits to borrowers; and (b) they contribute to a higher recovery of loan principal in the short run, but in the long run they negatively affect it since borrowers may develop expectations about future exemptions. On the other hand, given the involvement of the elected local government officials in the credit committees and their authority for preparing

lists of potential borrowers and for recovering overdue loans, the sign of  $\alpha_4$  is expected to be negative.

The ELEC variable is used in the model to capture the effects of informal political intervention by socio-political leaders in rural loan allocation and recovery. The sign of  $\alpha_1$  is expected to be negative as these leaders are less likely to support any recovery drive by bank branch managers and/or any stringent borrower selection procedure during an election year which may cost them votes.

A BANK dummy variable is introduced in the model to capture the effects of organizational, managerial and environmental characteristics of the participating banks in rural lending. NCBs are expected to behave differently from the development banks since they are oriented towards making more commercially viable loans. The development banks, however, may be more effective in rural lending because of their specialization and longer experience in rural lending. The NCB branches have been making rural loans for the last 10 years, while the development bank branches have over 30 years of rural lending experience.

### **PARAMETER ESTIMATES AND ANALYSIS OF RESULTS**

The model parameters were estimated using an ordinary least squares regression model with pooled data for five banks for the 1980-89 period. The data were corrected for heteroskedasticity and auto-correlation. The parameters of restricted and unrestricted models were estimated to test the validity and significance of the dummy variables, that is, to test the null hypothesis that the coefficients for BANK, ELEC and INTExEM are equal

to zero. The Chow-test comparing the models rejected the null hypothesis. The parameter estimates reported in Table 3 have the expected signs and are significant. The model, significant at the 0.001 level, explains 94 percent of the variance in the loan recovery rate. The restricted model explains only 22 percent implying that the explanatory power of the intervention variables is much higher than the variable representing the real interest rate.

The negative and significant coefficients for the ELEC and CRCOM variables support the hypothesis that political intervention in rural loan allocation and recovery affects the recovery rate. The parameter estimate for the election variable implies that the recovery rate declines by about 25 percent points during an election year, while the significant negative coefficient for the CRCOM variable indicates that the credit committee variable contributed to a decline in the recovery rate by a little over 5 percent.

The INTEXEM coefficient is significant and positive implying that the interest exemption policy contributed positively to the recovery rate. However, the marginal recovery rate with respect to interest exemption is only 4.80, i.e., interest exemption contributed to an increase of about five percent in the recovery rate. This suggests that the interest exemption policy has a limited positive impact on short run loan recovery.

The coefficient for the inflation variable is negative and significant implying that a reduction in the real interest rate decreases the target loan recovery rate because future expectations of a high inflation rate reduce the time value of money. The size of the coefficient for the inflation variable and its level of significance in the unrestricted model changed considerably from the restricted model. In the restricted model, the coefficient for the inflation variable was -1.33 (significant at the 5 percent level), while it was -0.29



(insignificant at the 5 percent level, but significant at the 15 percent level) in the unrestricted model. In addition, the coefficient for the inflation rate variable compared with the intervention variable coefficients in terms of size and significance suggests relatively less importance for the former in loan recovery. This indicates that political intervention outweighs the effect of the inflation rate in loan recovery.

The difference in loan recovery between commercial and development banks is captured by the negative and significant BANK dummy variable. The negative coefficient of 17.17 implies that the recovery rate for the NCBs is lower than the development banks by 17 percentage points. Several factors may contribute to this difference: (a) development banks are specialized in making rural loans and may have developed a more appropriate technology for making and recovering rural loans because they have been operating in rural areas for over three decades; and (b) the commercial bank employees may not be as well trained in making target loans because commercial banks have been more oriented towards mobilizing deposits and making less risky non-target loans.

### **SUMMARY AND CONCLUSIONS**

The objective of this paper was to conduct an empirical test of the relationship between government intervention in rural loan allocation and recovery and the recovery rate of targeted rural loan in Bangladesh over the period 1980-1989. During this period, the recovery rate fell from over 50 percent to less than 20 percent. A regression model was developed in which the recovery rate is explained by five variables. Two financial policy variables were introduced to represent the years that interest exemptions and credit

committees were in effect. Two variables represented election years and the effects of nationalized commercial banks versus development banks. The fifth variable captured the differences in inflation rate over the period.

The empirical results of the model are consistent with our expectations of how political intervention affects target loan recovery in Bangladesh. Four important findings emerged from the analysis. First, interest exemption programs positively influence the recovery rate at least in the short run, while informal intervention proxied by the election variable and formal intervention represented by the credit committee variable negatively affect the recovery rate. Second, the inflation rate discourages borrowers from repaying loans because it reduces the real interest rate and creates future expectations of high inflation. Therefore, high real interest rates can be expected to increase recovery rates. Third, commercial banks have a lower loan recovery rate than development banks. This may be attributed to different loan portfolios, management ability, technology and the size of bank branches. Fourth, the effect of the intervention variables outweighs the effect of the inflation rate on loan recovery rates. The effectiveness of high real interest rates on the rural loan recovery rate appears to be undermined by the interventions associated with the political objective of getting re-elected. Privatizing the banks or giving public sector banks greater flexibility in setting interest rates, selecting borrowers and recovering delinquent loans could reduce the possibility of government interventions in rural financial markets. Variable interest rates, although introduced in Bangladesh in 1990, are not applicable in target rural lending. Furthermore, increasing interest rates may not be an effective method

to stimulate loan recovery if governments distort rural financial markets with political interventions.

Low loan recovery can be explained from different perspectives - economic, institutional and political economy. There is no denying that poor recovery rates in some cases are due to financial problems faced by borrowers. But, in addition, borrowers often do not repay loans and lenders can not energetically recover loans because of government interventions designed to increase the probability of winning elections. A failure to address this dimension in loan recovery analysis may lead to incorrect policies prescriptions. There is a growing evidence that for a given bank the recovery rate for government sponsored loans is lower than for loans made out of a bank's own resources (Aguilera). Improving the viability of rural banks in a developing country like Bangladesh requires the reduction or elimination of government intervention in loan allocation and recovery so that banks are free to make good loans and recover them. In addition, the reduction in these interventions will probably increase the effectiveness of financial policies, particularly interest rates, in improving rural loan allocation and recovery.



Table 1  
Rural Target Loan Recovery Rate<sup>a</sup>, 1980-89  
Year Ending June 30

Year	Nationalized Commercial Banks	Agricultural Development Banks	All Banks
(percent)			
1980-81	36.3	67.8	51.6
1981-82	31.3	67.9	50.6
1982-83	30.0	49.6	42.1
1983-84	32.4	49.9	42.8
1984-85	30.0	44.2	42.3
1985-86	20.7	30.6	26.5
1986-87	42.0	41.4	42.3
1987-88	17.3	27.2	24.3
1988-89	13.7	21.8	18.8

<sup>a</sup> Recovery rate is defined as percent of target loans recovered relative to total recoverable target loans including principal and interest.

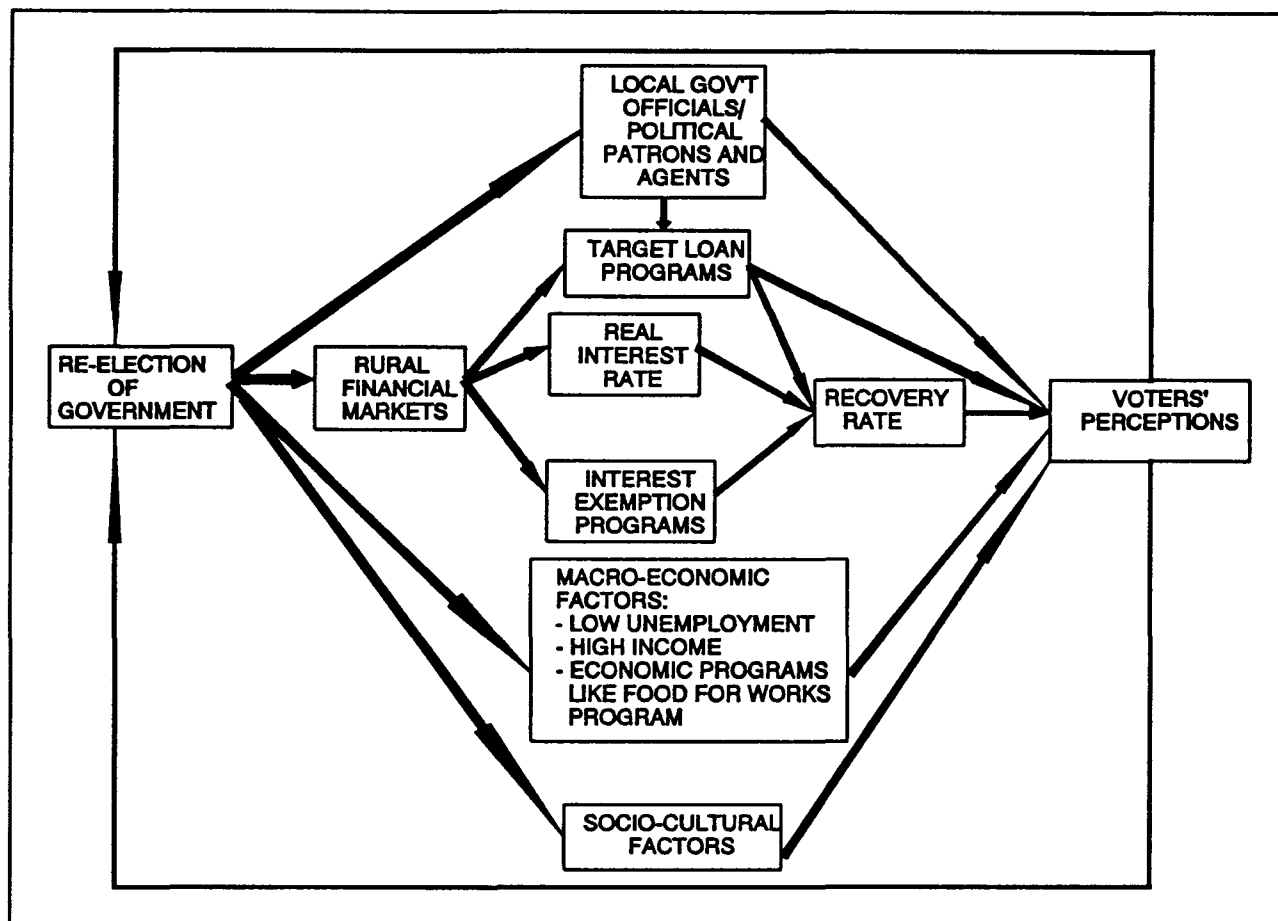
Source: Unpublished Data, Agricultural Credit Department, Bangladesh Bank.

Table 2

## Lending Rate Structure of Scheduled Banks, 1973-89

Effective Period	Major Loan Type			Inflation Rate
	Normal	Agricultural Target Loan	Industry	
1973-74	9.0-10.0	7.0	7.0-8.0	14.0
1974-75	12.0-13.0	11.0	12.0-13.0	70.2
1975-76	12.0-13.0	11.0	12.0-13.0	-23.8
1976-77	12.0-13.0	10.5	12.0-13.0	-3.3
1977-78	11.0-12.0	10.5	11.5-13.0	30.5
1978-79	11.0-12.0	10.5	11.5-13.0	13.0
1979-80	11.0-12.0	10.5	11.5-13.0	13.0
1980-81	15.5-16.0	12.0	14.0-14.5	10.5
1981-82	15.5-16.0	12.0	14.0-14.5	12.6
1982-83	15.5-16.0	12.0	14.0-14.5	4.9
1983-84	15.5-16.0	12.0	14.0-14.5	16.7
1984-85	16.0	16.0	14.5	14.7
1985-86	16.0	16.0	14.5	10.0
1986-87	16.0	16.0	14.5	10.9
1987-88	16.0	16.0	14.5	7.4
1988-89	16.0	16.0	14.5	7.6

Source: Economic Trends, August, 1991, Bangladesh Bank.



**Figure 1** Relationship between the Political Objective of Re-election and Intervention in Rural Financial Markets

Table 3  
Estimated Parameters of the Target Loan Recovery Function

Variable	Unrestricted Model		Restricted Model	
	Coefficient	t-ratio	Coefficient	t-ratio
Constant	57.60	5.31*	19.36	3.38*
Inflation (INFL)	- 0.29	-1.18***	-1.33	-2.63*
Interest Exemption (INTEXEM)	4.80	7.19*		
Election (ELEC)	-24.51	-6.53*		
Credit Committees (CRCOM)	-5.21	-1.58*		
Bank	-17.17	-2.32*		
R-square	0.94		0.22	

\* Significant at 5 percent level.

\*\* Significant at 10 percent level.

\*\*\* Significant at 15 percent level.



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**THE POLITICAL ECONOMY  
OF RURAL LOAN RECOVERY:  
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**Savings and Development**

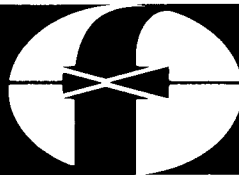
DEPT. OF ECON. & RUR. SOC.  
THE OHIO STATE UNIVERSITY  
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# THE POLITICAL ECONOMY OF RURAL LOAN RECOVERY: EVIDENCE FROM BANGLADESH

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## 1. Introduction

Until recently, banks and governments in many less developed countries considered providing cheap credit to rural households under the supply leading strategy as an effective method to achieve comprehensive rural development (Patrick). This approach has been challenged by several economists (Adams; Fry; Gonzalez-Vega; McKinnon; Shaw; Von Pischke) who argue that it leads to the inefficient allocation of resources and to credit-rationing because of excess loan demand and intervention in the lending decision-making process. The efficient allocation of funds has been at the front of this neo-liberal thesis. Interest rate reform has been the major policy prescription that has been proposed by reformers based on the argument that high interest rates would screen out the demand for credit for low rate of return projects. This approach has been accepted in several Asian countries including Bangladesh, Indonesia, Nepal and the Philippines. The Bangladesh government has adjusted its interest rate structure several times in recent years. Rural lending rates were increased significantly from 7 percent in 1973 to 16 percent in 1989. But the rural loan recovery rate declined sharply from 52 percent in 1983 to 18 percent in 1989 despite the interest rate reform. Such low recovery rates not only affect the viability of rural credit institutions, but also affect credit turnover (Khalily; Meyer and Srinivasan).

The problem of loan recovery in LDCs has been addressed by researchers from different perspectives. Often times it has been attributed to the idea that (a) rural loans are risky, and (b) rural borrowers are too poor to repay (Donald). Some analysts have argued that low recovery rates are due to lending policies, loan targeting, lender unwillingness to recover loans, and the management ability of bank employees (Braverman and Guash; Gregory et al., Maharajan et al., Von Pischke et al.). But a frequently overlooked problem is that borrowers are discouraged to repay and/or lenders can not recover loans because of political intervention in rural financial markets (Blair; Kane). This paper presents an empirical analysis of how political intervention affects rural loan recovery in Bangladesh, and shows how it undermines the effectiveness of positive real interest rates in stimulating loan recovery. Although politics are thought to affect loan recovery, no study has been found in the literature that reports an empirical test of the relationship.

Three basic expectations about loan recovery in Bangladesh provide the framework used in this paper. First, honest borrowers may not be able to repay loans on time because of fluctuations in production and/or unforeseen contingencies. However, a short-

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fall in income in one period may be offset by an increase in another period so honest borrowers are expected to eventually repay their loans. Second, delinquent borrowers that are under the political protection of their sponsors can avoid repaying loans. Third, government intervention in rural loan allocation and recovery, formally through financial policies and informally through local government officials and political leaders, negatively affect loan recovery.

## 2. The Rural Banking System and Target Loan Recovery

The banking sector in Bangladesh prior to 1981 was largely dominated by public sector banks - six Nationalized Commercial Banks (NCBs) and two Development Banks. There were only a few foreign banks in the private sector. But the policy of privatization adopted by the government in 1981 led to the denationalization of two of the NCBs and the creation of 10 local private banks. Like the foreign banks, the local private banks do not have branches in rural areas because they consider rural lending too risky. Apart from the cooperative system, today the rural financial markets in Bangladesh essentially consist of the branches of four nationalized commercial banks (NCBs) and two government-owned agricultural development banks (BKB and RAKUB). Since the public sector banks are predominant, government intervention can occur in rural loan allocation and recovery and can undermine the effectiveness of financial policies, particularly interest rates.

The rural banking system has undergone significant changes since 1977 because of the government's supply-leading financial strategy and the introduction of a "two-for-one" branching policy by the Bangladesh Bank (Central Bank). This branching policy required banks to open two rural branches for one urban branch so rural loans could be disbursed more effectively. As a result, the rural banking network expanded from 1,094 branches in 1977 to 2,851 in 1981. This growth slowed, however, following suspension of the policy in 1981. During the period 1976-91, the amount of total loans made increased by about 87 times, while the rural banking network increased by 8 times (Khaliq, Meyer and Hushak). Rural bank managers make two types of loans: target and non-target. Target loans are government sponsored loans made under terms and conditions set by the Bangladesh Bank, while non-target loans are made by banks using their own deposits. This paper analyzes the problem of recovering target loans.

The loan recovery rate is defined as the percentage of target loans recovered relative

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to total recoverable target loans (principal plus interest). Table 1 reports the target loan recovery rate by bank type. Three major findings emerge from the table. First, the recovery rate shows a declining trend from 1980-81 to 1988-89. Second, the recovery rate improved marginally in 1983-84 relative to the previous year, and substantially in 1986-87 relative to 1985-86. The government granted interest exemptions to borrowers in flood and cyclone affected areas in 1984, and to all borrowers in 1987. Interest exemptions are expected to stimulate recovery in the short run as borrowers take advantage of these special repayment conditions, but are expected to have a negative impact on long run recovery. Third, the recovery rate differs by the two bank types — commercial and development banks — probably because of the differences in management ability and banking technology.

Table 1

RURAL TARGET LOAN RECOVERY RATE<sup>a</sup>, 1980-89 - Year Ending June 30

Year	Nationalized Commercial Banks	Agricultural Development Banks	All Banks
	(percent)		
1980-81	36.3	67.8	51.6
1981-82	31.3	67.9	50.6
1982-83	30.0	49.6	42.1
1983-84	32.4	49.9	42.8
1984-85	30.0	44.2	42.3
1985-86	20.7	30.6	26.5
1986-87	42.0	41.4	42.3
1987-88	17.3	27.2	24.3
1988-89	13.7	21.8	18.8

<sup>a</sup> Recovery rate is defined as percent of target loans recovered relative to total recoverable target loans including principal and interest.

Source: Unpublished Data, Agricultural Credit Department, Bangladesh Bank.

Generally, most target loan borrowers try to repay their loans. Honest borrowers may not be able to repay loans when due because of production fluctuations or unforeseen contingencies, but it is expected that they will eventually repay. Meyer and Srinivasan, using data on short-term loans for the period 1979-84 for 89 rural bank branches, showed that about 70 percent of the principal amount of recoverable loans was recovered within five years after the due date. Borrowers under the political protection of their sponsors, however, have a lower repayment rate (Khaled). Khaled showed that elected chairmen

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and members of rural local governments who are the most powerful in terms of rural power structure and influence did not repay any loans and no legal actions were taken against them. Not only did they not repay their own loans, they were instrumental in supporting their clients to also not repay their loans. Consequently, the overall loan recovery rate has been negatively affected by political intervention.

### **3. Rural Power Structure, Politics and Rural Finance in Bangladesh**

Political intervention in the allocation of rural loans is quite common in developing countries. The government intervenes in the rural lending decision-making process as a tool for getting re-elected. One of the crucial factors in affecting elections is the perception of voters. There are at least two ways for a regime to influence voter perceptions: (a) through achieving economic growth with low inflation and unemployment (Frey and Schneider); and (b) through distributing economic and financial benefits directly to voters. In a developing country like Bangladesh where democratic institutions are weak and the government has been unstable, it is difficult for a government to influence voter decisions through the first approach. The latter approach appears to be more popular with the government as it tries to directly influence voter decisions.

Since the majority of the voters live in rural areas, the government can try to influence their decisions by distributing financial benefits to them through rural financial markets in two ways: first, formally through rural financial and lending policies, and, secondly, informally through socio-political leaders. The role of socio-political leaders depends on the rural social structure. When socio-political leaders play a dominate role in the rural society, the government may ensure their participation in local government and rural financial markets.

In a faction based rural society as in Bangladesh, the traditional rural power structure is dominated by big farmers (Bertocci; Chowdhury; Islam; Wood; Zaidi). In each faction large landowners represent the patrons, while the other members of the faction are the clients. The nature of the relationship between patrons and clients and the degree of influence of the patrons dictates the pattern of linkage between national and rural politics through different types of economic and financial policies. Empirical studies have shown that large landowners and faction leaders dominate the local rural government units (Chowdhury; Rahman; Wood). Because of the influence of these large landowners and faction leaders who are patrons over the members of their factions, they are patronized

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by the government through their role in local government and their involvement in the distribution of relief goods in food for work programs and agricultural credit (Chowdhury; Tepper; Wood). Islam identified three types of brokers that link rural villages with urban areas in Bangladesh. First, there are a group of brokers who patronize their clients and voters. The local political leaders and local government officials belong to this group. The second group consists of educated people and traders acting as middlemen between government officials and rural people. The third group of brokers are urban agents of political parties who by their association with the bureaucrats and political leaders in power can promote public issues and initiate development programs for the rural people. A similar conclusion regarding rural social and power structure was also found by Wood. Given this pattern of rural social and power structure and the relationship between rural and national politics, a government can maximize its political gains by patronizing the rural patrons through its programs and rural financial policies.

#### **4. Formal Intervention through Financial Policies**

The Agricultural Credit Department (ACD) of the Bangladesh Bank designs target loan programs and sets the terms and conditions such as the eligibility of borrowers, maximum amount to be lent per loan, nature of loan supervision, and type of loan documentation that is required. The amount of target loans to be distributed by a bank is also set by the ACD. The target for each bank branch is set by its central office based on local economic characteristics and the operational size of the branch. As noted above, the distribution and recovery of target loans is constrained by financial policies which permit the government to formally intervene in the lending and recovery program of rural branches. The major policies that are likely to affect the rural loan recovery rate are interest rates, credit committees, and interest exemptions.

##### **4.1. Rural Lending Interest Rate Structure**

The nominal interest rate structure for rural loans has been changed five times during the period 1973-89 (Table 2). Interest rates on short term target loans were more than doubled from seven percent in 1973 to sixteen percent in 1989. The major changes were made during the 1980s and the present interest rate of 16 percent was introduced in 1983. Given a low and declining inflation rate since the early 1980s, the 1983 increase contributed to a positive real interest rate. Real interest rates increased from

one percent in 1983 to about 9 percent in 1989. Prior to 1983, however, the real interest rate was negative and was as high as a negative 70 percent. Although the real interest rate on rural target loans has increased significantly the past two decades, the loan recovery rate declined sharply from 52 percent in 1983 to 18 percent in 1989. This inverse relationship appears to be inconsistent with the neo-liberal thesis about interest rates. The problem is that although interest rates increased, the political intervention in rural loan allocation and recovery continued to exist. Therefore, the effectiveness of high positive real interest rates in influencing a more efficient allocation and recovery of loans has been undermined by political intervention and other policy distortions.

Table 2

LENDING RATE STRUCTURE OF SCHEDULED BANKS, 1973-89

Effective Period	Major Loan Type			Inflation Rate
	Normal	Agricultural Target Loan	Industry	
1973-74	9.0-10.0	7.0	7.0- 8.0	14.0
1974-75	12.0-13.0	11.0	12.0-13.0	70.2
1975-76	12.0-13.0	11.0	12.0-13.0	-23.8
1976-77	12.0-13.0	10.5	12.0-13.0	-3.3
1977-78	11.0-12.0	10.5	11.5-13.0	30.5
1978-79	11.0-12.0	10.5	11.5-13.0	13.0
1979-80	11.0-12.0	10.5	11.5-13.0	13.0
1980-81	15.5-16.0	12.0	14.0-14.5	10.5
1981-82	15.5-16.0	12.0	14.0-14.5	12.6
1982-83	15.5-16.0	12.0	14.0-14.5	4.9
1983-84	15.5-16.0	12.0	14.0-14.5	16.7
1984-85	16.0	16.0	14.5	14.7
1985-86	16.0	16.0	14.5	10.0
1986-87	16.0	16.0	14.5	10.9
1987-88	16.0	16.0	14.5	7.4
1988-89	16.0	16.0	14.5	7.6

Source: Economic Trends, August, 1991, Bangladesh Bank.

#### 4.2. Credit Committees

Credit Committees, created at the direction of the government in 1983, were intended to be involved in both the process of allocating and recovering target loans. These committees exist at the three tiers of local government — Union Council, Upazila and District. The credit committee at the union level, consisting of the chairman and members of

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the council, bank branch managers and block agricultural extension supervisors, is involved in rural lending by preparing lists of potential borrowers, by recommending loan amounts, and by assisting bank managers in recovering delinquent target loans. The committees at the upazila and district levels are essentially entrusted with the tasks of general supervision and follow up.

The effectiveness of these committees in the allocation and recovery of target loans is questionable since the chairman and committee members are elected by the voters for four-year terms. In addition, there is no defined criteria for use in preparing the list of potential borrowers. The re-election objective of elected local government officials is likely to enter into the preparation of these lists. They are likely to promote or sponsor their particular clients and expand their political base for re-election by including in the list the names of their clients and potential voters. The loan recovery authority assigned to the credit committee is likely to affect the loan recovery efforts of the branch managers. Until 1987, the rural branch managers did not have any flexibility and authority in selecting borrowers, except to choose persons included in the list, and in recovering targeted rural loans. In 1987, the branch managers were finally given absolute authority and responsibility to select borrowers, and to disburse, monitor and recover targeted rural loans.

#### *4.3. Interest Exemption Programs*

Five interest exemption programs were implemented during the 1982-1991 period. The basic objectives were to ease the loan burden of the borrowers and to encourage them to repay overdue loans. The interest exemption programs announced in 1984 and 1985 provided for interest exemptions and loan rescheduling without any penalty interest for borrowers affected by natural calamities. The 1985 announcement exempted interest only for cyclone-affected borrowers. It did not, however, provide for loan rescheduling (Rashid). The 1986 and 1987 interest exemption programs aimed at improving the recovery rate and were applicable country-wide for all types of crop loans up to Taka 10,000<sup>1</sup> (including principal, interest, and service charges). The announcement in 1991 by the new democratically elected government as part of its election promise exceeded the earlier exemptions in terms of coverage. It provided for exemption of principal, interest and overdue interest penalties up to Taka 5,000. The earlier announcements

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<sup>1</sup> In this period, 30 Taka were approximately equal to \$1 US dollar.

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generally did not provide for principal exemption. The 1991 announcement not only contributed to revenue loss but also to capital loss for the banks because the exempted principal means that the banks have to compensate depositors out of their capital and/or profits. The total cost of the 1991 announcement for the commercial and development banks has been estimated at 350 million Taka.

There has been no significant study of the effects of the interest exemption programs on loan recovery rates. But the frequency of these programs has contributed to expectations about future interest exemptions and this is expected to contribute to the low and declining recovery rates.

### 5. Informal Intervention through Elections

In addition to its direct formal intervention in financial markets through policy-making, the government can also informally intervene in the target loan allocation and recovery efforts of bank branch managers. A government is not likely to support a loan recovery drive and strict borrower selection procedures during an election period because of the negative impact it may have on some borrowers. During an election period, local government officials and elected representatives will likely intervene in target loan allocation and/or recovery efforts so that potential voters can more easily get loans and borrowers can avoid the pressure of bank officials to repay loans. This informal intervention by local political leaders and government officials may always exist but its intensity is likely to increase in election years.

### 6. A Loan Recovery Model

A simple recovery model was developed for this study to evaluate the impact of political interventions in rural target loan recovery based on the literature reviewed and the nature of the interventions discussed above. Following Frey and Schneider, the general framework of the model is specified as follows:

$$\begin{aligned} & \text{MAX } U(.) \\ & \text{S.T. } V(t) > V(t)^* \end{aligned} \quad (1)$$

$$V(t) = f(\text{POLIT}, \text{ECOPOL}, \text{RFMPOL}, \text{SOCIO}) \quad (2)$$


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The basic objective of government is to maximize its utility function of getting re-elected subject to the constraints (1) and (2). Constraint (1) specifies that the government will have to get a minimum number of votes,  $V(t)^*$ , to be re-elected. The second constraint indicates that the voting decision of voters is a function of political intervention (POLIT), macro-economic developments (ECOPOL), rural financial policies of the government (RFMPOL) and other socio-cultural (SOCIO) factors.

Constraint (2) establishes the relationship between the political motives of the government and the recovery behavior of rural bank branches which is shown in Figure 1. As diagramed, the basic objective of the government is to influence voter perceptions through local political leaders, rural financial markets, macro-economic variables and other socio-cultural factors. A low recovery rate is assumed to positively influence voter perceptions towards the government.

Four policy variables — interest rates, interest exemptions, credit committees and informal intervention in loan allocation and recovery — are identified as the ways the rural financial markets influence voter decisions and the loan recovery rate. The equation explaining loan recovery behavior is specified as:

$$\text{Recovery} = \alpha_0 + \alpha_1 \text{ELEC} + \alpha_2 \text{INFL} + \alpha_3 \text{INTEXEM} + \alpha_4 \text{CRCOM} + \alpha_5 \text{BANK} \quad (3)$$

where INTEXEM (interest exemptions) and CRCOM (credit committees) are dummy variables representing financial policy variables that are given the value of one in the years when interest exemptions and credit committees are in effect, and zero otherwise. The variables representing ELEC and BANK are dummy variables in which election years, and NCBs are given the value of one and zero otherwise. INFL (inflation) represents both macro-economic reforms and real interest rates. Since nominal interest rates are constant for all banks, the inflation rate influences real interest rates. It has been argued that as inflation reduces the real interest rate it may negatively affect recovery if borrowers develop expectations of high future inflation rates (Von Pischke et al.). The recovery equation is expressed in linear form and the estimation errors are assumed to be normally distributed.

Formal government intervention through financial policies is captured, as discussed above, by variables representing credit committees and interest exemption programs. Interest exemption programs are expected to have two major effects: (a) they generate political support for the government in election years since they provide direct financial benefits to borrowers; and (b) they contribute to a higher recovery of loan principal in

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the short run, but in the long run they negatively affect it since borrowers may develop expectations about future exemptions. On the other hand, given the involvement of the elected local government officials in the credit committees and their authority for preparing lists of potential borrowers and for recovering overdue loans, the sign of  $\alpha_4$  is expected to be negative.

The ELEC variable is used in the model to capture the effects of informal political intervention by socio-political leaders in rural loan allocation and recovery. The sign of  $\alpha_1$  is expected to be negative as these leaders are less likely to support any recovery drive by bank branch managers and/or any stringent borrower selection procedure during an election year which may cost them votes.

A BANK dummy variable is introduced in the model to capture the effects of organizational, managerial and environmental characteristics of the participating banks in rural lending. NCBs are expected to behave differently from the development banks since they are oriented towards making more commercially viable loans. The development banks, however, may be more effective in rural lending because of their specialization and longer experience in rural lending. The NCB branches have been making rural loans for the last 10 years, while the development bank branches have over 30 years of rural lending experience.

## 7. Parameter Estimates and Analysis of Results

The model parameters were estimated using an ordinary least squares regression model with pooled data for five banks for the 1980-89 period. The data were corrected for heteroskedasticity and auto-correlation. The parameters of restricted and unrestricted models were estimated to test the validity and significance of the dummy variables, that is, to test the null hypothesis that the coefficients for BANK, ELEC and INTXEM are equal to zero. The Chow-test comparing the models rejected the null hypothesis. The parameter estimates reported in Table 3 have the expected signs and are significant. The model, significant at the 0.001 level, explains 94 percent of the variance in the loan recovery rate. The restricted model explains only 22 percent implying that the explanatory power of the intervention variables is much higher than the variable representing the real interest rate.

The negative and significant coefficients for the ELEC and CRCOM variables support the hypothesis that political intervention in rural loan allocation and recovery affects the recovery rate. The parameter estimate for the election variable implies that the

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recovery rate declines by about 25 percent points during an election year, while the significant negative coefficient for the CRCOM variable indicates that the credit committee variable contributed to a decline in the recovery rate by a little over 5 percent.

**Table 3**  
ESTIMATED PARAMETERS OF THE TARGET LOAN RECOVERY FUNCTION

Variable	Unrestricted Model		Restricted Model	
	Coefficient	t-ratio	Coefficient	t-ratio
Constant	57.60	5.31*	19.36	3.38*
Inflation (INFL)	-0.29	-1.18***	-1.33	-2.63*
Interest Exemption (INTEXEM)	4.80	7.19*		
Election (ELEC)	-24.51	-6.53*		
Credit Committees (CRCOM)	-5.21	-1.58*		
Bank	-17.17	-2.32*		
R-square	0.94		0.22	

\* Significant at 5 percent level.  
 \*\* Significant at 10 percent level.  
 \*\*\* Significant at 15 percent level.

The INTEXEM coefficient is significant and positive implying that the interest exemption policy contributed positively to the recovery rate. However, the marginal recovery rate with respect to interest exemption is only 4.80, i.e., interest exemption contributed to an increase of about five percent in the recovery rate. This suggests that the interest exemption policy has a limited positive impact on short run loan recovery.

The coefficient for the inflation variable is negative and significant implying that a reduction in the real interest rate decreases the target loan recovery rate because future expectations of a high inflation rate reduce the time value of money. The size of the coefficient for the inflation variable and its level of significance in the unrestricted model chang-

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ed considerably from the restricted model. In the restricted model, the coefficient for the inflation variable was -1.33 (significant at the 5 percent level), while it was -0.29 (insignificant at the 5 percent level, but significant at the 15 percent level) in the unrestricted model. In addition, the coefficient for the inflation rate variable compared with the intervention variable coefficients in terms of size and significance suggests relatively less importance for the former in loan recovery. This indicates that political intervention outweighs the effect of the inflation rate in loan recovery.

The difference in loan recovery between commercial and development banks is captured by the negative and significant BANK dummy variable. The negative coefficient of 17.17 implies that the recovery rate for the NCBs is lower than the development banks by 17 percentage points. Several factors may contribute to this difference: (a) development banks are specialized in making rural loans and may have developed a more appropriate technology for making and recovering rural loans because they have been operating in rural areas for over three decades; and (b) the commercial bank employees may not be as well trained in making target loans because commercial banks have been more oriented towards mobilizing deposits and making less risky non-target loans.

## 8. Summary and Conclusions

The objective of this paper was to conduct an empirical test of the relationship between government intervention in rural loan allocation and recovery and the recovery rate of targeted rural loan in Bangladesh over the period 1980-1989. During this period, the recovery rate fell from over 50 percent to less than 20 percent. A regression model was developed in which the recovery rate is explained by five variables. Two financial policy variables were introduced to represent the years that interest exemptions and credit committees were in effect. Two variables represented election years and the effects of nationalized commercial banks versus development banks. The fifth variable captured the differences in inflation rate over the period.

The empirical results of the model are consistent with our expectations of how political intervention affects target loan recovery in Bangladesh. Four important findings emerged from the analysis. First, interest exemption programs positively influence the recovery rate at least in the short run, while informal intervention proxied by the election variable and formal intervention represented by the credit committee variable negatively affect the recovery rate. Second, the inflation rate discourages borrowers from repaying loans

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because it reduces the real interest rate and creates future expectations of high inflation. Therefore, high real interest rates can be expected to increase recovery rates. Third, commercial banks have a lower loan recovery rate than development banks. This may be attributed to different loan portfolios, management ability, technology and the size of bank branches. Fourth, the effect of the intervention variables outweighs the effect of the inflation rate on loan recovery rates. The effectiveness of high real interest rates on the rural loan recovery rate appears to be undermined by the interventions associated with the political objective of getting re-elected. Privatizing the banks or giving public sector banks greater flexibility in setting interest rates, selecting borrowers and recovering delinquent loans could reduce the possibility of government interventions in rural financial markets. Variable interest rates, although introduced in Bangladesh in 1990, are not applicable in target rural lending. Furthermore, increasing interest rates may not be an effective method to stimulate loan recovery if governments distort rural financial markets with political interventions.

Low loan recovery can be explained from different perspectives - economic, institutional and political economy. There is no denying that poor recovery rates in some cases are due to financial problems faced by borrowers. But, in addition, borrowers often do not repay loans and lenders can not energetically recover loans because of government interventions designed to increase the probability of winning elections. A failure to address this dimension in loan recovery analysis may lead to incorrect policies prescriptions. There is a growing evidence that for a given bank the recovery rate for government sponsored loans is lower than for loans made out of a bank's own resources (Aguilera). Improving the viability of rural banks in a developing country like Bangladesh requires the reduction or elimination of government intervention in loan allocation and recovery so that banks are free to make good loans and recover them. In addition, the reduction in these interventions will probably increase the effectiveness of financial policies, particularly interest rates, in improving rural loan allocation and recovery.

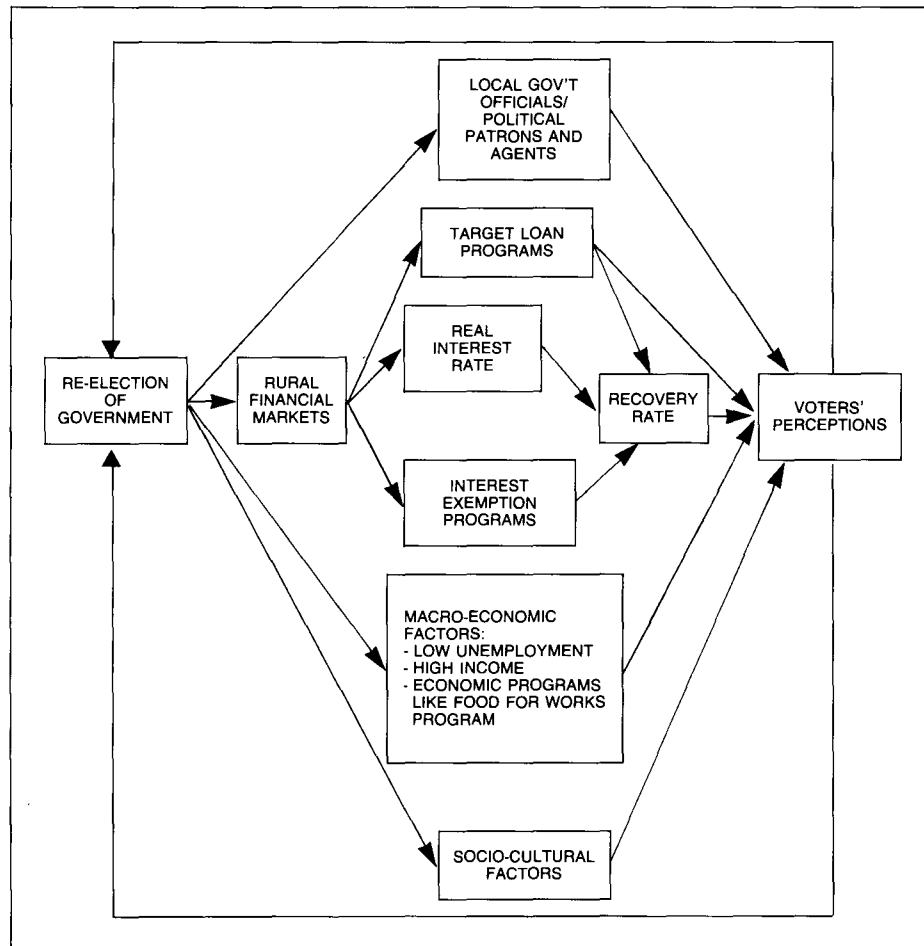


Figure 1 Relationship between the Political Objective of Re-election and Intervention in Rural Financial Markets.

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**Abstract**

*The rural loan recovery problem in developing countries is frequently analyzed from the perspective of borrowers or financial institutions. But a frequently overlooked problem is that borrowers often are discouraged to repay and/or institutions are not aggressive in loan recovery because governments intervene in rural financial markets to increase the prospects of getting re-elected. This political intervention may undermine the effectiveness of measures such as increasing real interest rates to improve loan allocation and recovery. A failure to address this political dimension in loan recovery analysis may lead to incorrect policy prescriptions. This paper provides an empirical analysis of how political interventions affect rural loan recovery in Bangladesh in the period 1980 to 1989. The results indicate that the negative effect of political intervention in loan allocation and recovery outweighs the effect of positive real interest rates. The government in Bangladesh intervenes in rural loan allocation and recovery formally through policies — interest exemptions, credit committees and interest rates — and informally through elected local government officials and local socio-political leaders. The intensity of informal intervention is expected to increase during an election period. Five variables — inflation rate, election years, interest exemption years, credit committee years and bank type — were included in the model used to explain loan recovery. The empirical results showed that elections, inflation rates, credit committees, and bank type affect rural loan recovery negatively, while interest exemptions affect it positively.*



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**RASSEGNA TRIMESTRALE**

REGISTRATA PRESSO IL TRIBUNALE DI MILANO AL N. 102 DEL 27.3.1974  
DIREZIONE, REDAZIONE, AMMINISTRAZIONE  
FINAFRICA CARIPLO - VIA S. VIGILIO, 10 - 20142 MILANO

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Arti Grafiche FRIMA s.r.l. - Milano

